

**Module K**

**Other Requirements Applicable to  
Certain Qualified Private Activity  
Bonds**



## Module K

# Other Requirements Applicable to Certain Qualified Private Activity Bonds

## Overview

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### Introduction

You will recall from IRC section 103(b) that in order for the interest on a private activity bond to be tax-exempt, the bond must:

- be a qualified private activity bond,
- not be an arbitrage bond, AND
- meet the requirements of IRC section 149.

In order to be a qualified private activity bond, IRC section 141(e) provides that a bond must:

- meet the requirements of IRC sections 142, 143, 144, or 145, depending on the type of bond,
- meet the volume cap requirements of IRC section 146, AND
- meet the applicable requirements of IRC section 147.

Module K discusses the rules set forth in IRC section 147. These are general rules which apply only to certain qualified private activity bonds. They do NOT apply to governmental bonds. This module is divided into seven sections, as indicated below.

Failure to comply with these requirements precludes tax exemption for the interest on the bonds.

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## Overview, Continued

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### Legislative History

The Tax Reform Act of 1986 added section 147 to the Code. Prior to 1986, provisions parallel to those in IRC section 147 were found throughout section 103 of the 1954 Code, as shown below:

Subject	1986 Code	1954 Code
Substantial user	147(a)	103(b)(13)
Maturity limitations	147(b)	103(b)(14)
Land acquisition	147(c)	103(b)(16)
Existing property	147(d)	103(b)(17)
Skyboxes, airplanes, etc	147(e)	103(b)(18)
Public approval	147(f)	103(k)
Issuance costs	147(g)	NA
Applicability	147(h)	NA

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### Objectives

At the end of this module the student will be able to:

- Identify a substantial user.
  - Explain the effect that a substantial user can have on the tax-exempt status of any bonds purchased and held by him/her.
  - Determine if the maturity limitation has been met.
  - Explain the limitations on use of proceeds for land acquisition.
  - Explain the limitations on acquisitions of existing property.
  - Identify the facilities which cannot be funded with tax-exempt bonds.
  - Explain the public approval requirements.
  - Explain the restrictions on use of proceeds for issuance costs.
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## Overview, Continued

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# Section 1

## Substantial User Requirement

### Overview

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**Introduction** IRC section 147(a) provides that interest paid on any qualified private activity bond is included in gross income of a substantial user (or a related person of a substantial user) for any period during which such obligation is held by a substantial user or related person. The crux of this subsection is the identification of a “substantial user.”

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**Statutory Provisions** IRC section 147(a) provides the general rules regarding the substantial user requirement. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(13) of the 1954 Code.

Treas. Reg. section 1.103-11 provides rules applicable to the substantial user requirement.

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**Applicability** IRC section 147(h) provides that IRC section 147(a) does not apply to the following types of bonds:

- qualified mortgage bonds,
- qualified veterans’ mortgage bonds,
- qualified student loan bonds, AND
- qualified 501(c)(3) bonds.

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**In This Section** This section contains the following topics:

Topic	See Page
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Substantial User	K-5
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# Substantial User

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## **General Definition**

Treas. Reg. section 1.103-11(b) provides that a substantial user of a facility includes any nonexempt person who regularly uses a part of the facility in a trade or business. However, unless the facility was constructed, reconstructed, or acquired specifically for a nonexempt person, a nonexempt person will be a substantial user of a facility only if:

- the gross revenue derived by such user with respect to the facility is more than five percent of the total revenue derived by all users of the facility, OR
  - the amount of area of the facility occupied by the user is more than five percent of the entire usable area of the facility.
- 

## **Definition of a Nonexempt Person**

Treas. Reg. section 1.103-7(b)(2) provides the definition of an “exempt person” as:

- a governmental unit, or
- a 501(c)(3) organization, but only with respect to its related activities.

Therefore a nonexempt person is any entity other than those identified above.

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## **Example 1**

In Rev. Rul. 76-406, 1976-2 CB 30, members of a tax-exempt farmers’ cooperative purchased industrial development bonds, issued as an exempt small issue by a political subdivision of a state, to finance the construction of a slaughter house and marketing facility to be leased to the cooperative for the benefit of its members. Even though none of the members derived more than five percent of the total revenue or occupied more than five percent of the usable space of the facility, the facility was constructed for and is operated for use in the members’ cattle business. Therefore, all of the members are treated as substantial users. Any interest the members receive on the bonds is included in their gross income.

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## Substantial User, Continued

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### Example 2

In PLR 8003059, bonds were issued to finance the acquisition of land and construction thereon of a building to be used by a society as its headquarters. Members of the society were certified public accountants. The society planned to use the building for purposes that generally promoted the common interests of members. Although the society provided some services to its members, the building would not be used by any of the members as a site for providing services to their clients. The society offered the bonds for sale to its members. The members were not determined to be substantial users because they would not receive any significant commercial or economic benefit from the operation of the building in their trades or businesses as accountants.

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### Other Arrangements

Treas. Reg. section 1.103-11(b) provides that a nonexempt person may be a substantial user, if any of the following apply:

- has a contractual or preemptive right to the exclusive use of all or a portion of the property,
- is a lessee or sublessee of all or any portion of the facility, OR
- is a licensee whose use of the facility is regular and NOT merely casual, infrequent, or sporadic.

Individuals who are physically present on or in the facility as employees of a substantial user are usually NOT substantial users.

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### Example 3

Corporation X, a nonexempt person, borrows the entire principal amount of \$4M of County A's bonds. The bonds are qualified small issue bonds used to finance construction of a manufacturing facility, which will be leased to Corporation X for an annual rental of \$500,000. Corporation X subleases space to a restaurant operator at an annual rental of \$25,000. The restaurant is open five days a week from 8am until 5pm. The space physically occupied and the amount of revenue derived by the restaurant operator are more than five percent of the respective amounts with respect to the entire facility. Both Corporation X and the restaurant operator are substantial users of the facility. Corporation X is a substantial user because the facility was constructed specifically for its use. The restaurant operator is a substantial user because the space occupied and revenues earned by it exceed five percent of that of the entire facility. (See **Treas. Reg. section 1.103-11(c) Example 1.**)

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## Substantial User, Continued

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### Example 4

City B proposes to issue \$2M of bonds which qualify as qualified small issue bonds, to construct a medical building for certain dentists and physicians. The facility will contain thirty offices to be leased on equal terms and for the same rental rates to each physician or dentist for use in his trade or business.

Each physician or dentist will be a substantial user of the facility since the facility is being constructed specifically for such physicians and dentists. The result would be the same if the office building were for general commercial use.

**(See Treas. Reg. section 1.103-11(c) Example 3.)**

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### Example 5

Authority E issues \$4M of bonds which qualify as qualified small issue bonds in order to construct a bank building on the grounds of an airport. The authority also issues \$40M to expand the airport. The bank will not derive revenue in excess of five percent of the revenue derived with respect to the airport nor will it occupy more than five percent of the usable area of such airport.

The bank will be a substantial user of the bank building because the facility was constructed specifically for the bank. However, the bank will NOT be a substantial user with respect to the airport because it does not exceed the five-percent limitations.

If Authority E had issued one issue of \$44M in order to expand the airport and construct a bank building, the bank would be a substantial user of the entire facility since the \$44M issue was being used to construct a facility a portion of which was specifically for the bank. **(See Treas. Reg. section 1.103-11(c) Example 6.)**

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## Related Person

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### Definition

IRC section 147(a)(2) provides that the following will be treated as related persons:

- two or more persons if the relationship between such persons would result in a disallowance of losses under IRC section 267 or 707(b),
  - two or more persons which are members of the same controlled group of corporations (as defined in IRC section 1563(a), except that “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears therein),
  - a partnership and each of its partners (and their spouses and minor children),  
AND
  - an S corporation and each of its shareholders (and their spouses and minor children).
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## Section 2

### Maturity Limitation

#### Overview

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**Introduction** To prevent bonds from remaining outstanding longer than necessary, IRC section 147(b) limits the average length of maturity of certain qualified private activity bonds.

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**Statutory Provisions** IRC section 147(b) provides the general rules regarding the maturity limitation. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(14) of the 1954 Code.

Treas. Reg. section 1.147(b)-1 provides rules applicable to the maturity limitation.

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**General Rule** IRC section 147(b) provides that interest paid on any qualified private activity bond is included in gross income if the average maturity of the bonds issued EXCEEDS 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of the issue.

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**Applicability** IRC section 147(h) provides that IRC section 147(b) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
- qualified veterans' mortgage bonds, AND
- qualified student loan bonds.

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**Exception for Working Capital Financings** Treas. Reg. section 1.147(b)-1 provides that IRC section 147(b) does not apply to bond proceeds used to finance working capital expenditures. (Remember that only proceeds of qualified 501(c)(3) bonds can be used to finance working capital expenditures.)

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## Overview, Continued

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**In This Section** This section contains the following topics:

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## Average Maturity of the Bonds

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**Determination of Average Maturity** IRC section 147(b)(2)(A) provides that the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of the entire issue.

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**Computation** The following example illustrates the computation of the average maturity of bonds:

Example

City K issues \$5M principal amount of bonds, which are sold at par on January 1, 1998. The issue prices and maturity dates are shown below:

<b>Maturity Date</b>	<b>Issue Price</b>
1999	\$1M
2000	\$1M
2001	\$1M
2003	\$2M

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There are three steps involved in the computation:

1. Multiply each issue price by the number of years remaining until maturity.
2. Add all of these products together.
3. Divide this sum by the principal amount of the bonds.

The computation below shows that the weighted average maturity of these bonds is 3.2 years.

<b>Issue Price</b>	<b>Number of Years Until Maturity</b>	<b>Product</b>
\$1M	1	1M
\$1M	2	2M
\$1M	3	3M
\$2M	5	<u>10M</u>
<b>SUM OF PRODUCTS</b>		16M
<b>DIVIDED BY PRINCIPAL AMOUNT</b>		16M/5M = 3.2

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## Economic Life

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### Determination of Average Reasonably Expected Economic Life

IRC section 147(b)(2)(B) provides that the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Obviously, then, the determination of the economic life of the facility AND the total cost of the facility are the most significant aspects of IRC section 147(b).

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### Determination date

IRC section 147(b)(3)(A) provides that the reasonably expected economic life of any facility shall be determined as of the LATER OF:

- the date on which the bonds are issued, OR
  - the date on which the facility is placed in service (or expected to be placed in service.)
- 

### Determination of economic life

The House Conference Report No. 97-760, August 17, 1982 at pages 519 and 520 provides that the economic life of assets is determined on a case-by-case basis. However, the conferees intend that guidelines established for useful lives used for depreciation prior to the ACRS (the midpoint lives under the ADR system or guidelines provided by Rev. Proc. 87-56, 1987-2 CB 674 and Rev. Proc. 62-21, 1962-2 CB 418 in the case of structures) may be used. Further, the issuer can use longer lives when it can show that the economic life of the asset is actually longer than that established by the guidelines.

Rev. Proc. 87-56 is included at the end of this module as **Exhibit K-1**. Rev. Proc. 88-22, 1988-1 CB 785, which clarifies and modifies Rev. Proc. 87-56, is included as **Exhibit K-2**.

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### Treatment of land

IRC section 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land.

When land is taken into account, it is treated as having an economic life of 30 years.

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## Economic Life, Continued

**Computation of average economic life** The following example illustrates the computation of average economic life.

**Example**

Hospital System M borrows the proceeds of State B's bonds to build a parking garage. The building and its components along with their economic lives and respective costs are listed below:

ASSET	ECONOMIC LIFE	COST
Masonry multilevel parking structure	25	\$2,000,000
Roof covering	10	\$50,000
Electric lighting	15	\$10,000
Passenger elevator	20	<u>\$5,000</u>
<b>Total cost</b>		<b>\$2,065,000</b>

Computation of the average economic life is similar to that of the average maturity and involves three steps:

1. Multiply the economic life by the cost of the asset.
2. Add together all of these products.
3. Divide this sum by the total cost of the assets.

The computation shown below shows the average economic life of 24.58 years. Therefore, the average maturity of the bonds cannot be more than 29.5 years (120 percent of 24.58 years.)

Economic Life	Cost	Product
25	\$2,000,000	50,000,000
10	\$50,000	500,000
15	\$10,000	150,000
20	\$5,000	<u>100,000</u>
<b>SUM OF PRODUCTS</b>		<b>50,750,000</b>
<b>DIVIDED BY TOTAL COST</b>		50,750,000/2,065,000= 24.58 yrs

## Special Rule for Pooled Financings of Qualified 501(c)(3) Bonds

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**General Rule** IRC section 147(b)(4) provides that for pooled issues where 95 percent or more of the net proceeds of the issue are used to make loans to 501(c)(3) organizations or governmental units for acquisition of property, **at the election of the issuer**, compliance with the 120 percent rule is determined by comparing the average maturity of each loan to the expected economic life of the facilities being financed by that loan.

### Example

Charity Q and Charity R borrow proceeds from City A. The average economic life is computed for each charity's property separately. If Charity Q plans to acquire property having a 10-year ADR midpoint life, the maximum loan term permitted for Charity Q's loan is 12 years. If Charity R plans to acquire two properties, each with a different class life, then a weighted average economic life would be used as under the general 120 percent rule.

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**Requirements** IRC section 147(b)(4)(B) provides that in order to make this election, the bonds must meet the following requirements:

- 95 percent or more of the net proceeds of the issue must be used to finance loans to two or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations.
- the average maturity of each loan must not exceed 120 percent of the average reasonably expected economic life of the facilities financed by that loan,
- before the bonds are issued, there must be a demand survey which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of the issue,
- 95 percent or more of the net proceeds of the issue are to be loaned to 501(c)(3) organizations or governmental units within one year of issuance,
- any unspent proceeds after one year are to be used to redeem the bonds as soon as possible, but not later than 18 months after issuance, AND
- the maturity date of the bonds must not exceed 30 years.

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**Making the election** Treas. Reg. 301.9100-7T(g) provides that an election under IRC section 147(b)(4)(A) must be made in the bond indenture or a related document on or before the date of issue.



# Auditing Techniques

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## **Form 8038**

The weighted average maturity of the bonds can be found in Part III of Forms 8038 and 8038-G. An estimate of the weighted average maturity of the bonds can be found in Part II of Form 8038-GC. **(Refer to Exhibits B1, B2, and C1.)**

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## **Average economic life**

Information regarding the economic lives of bond-financed assets can be found in the conduit borrower's depreciation schedules. ~~These schedules are used as a guide only, and do not determine conclusively the economic life of an asset.~~

TEFRA legislative history recommends use of mid-point ADR class lives.

Industry guides can also be used. The American Hospital Association publishes a depreciation guide every five years (1978, 1983, 1988, 1993). Other industry guides are most likely available as well. Check with the conduit borrower or an IRS industry specialist.

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## **Verifying the maturity limitation**

When verifying the maturity limitation:

- Compare the figure on Form 8038 with the average economic life of the bond-financed assets.
  - Verify that the figure was calculated correctly. Request calculations from issuer, conduit borrower, or trustee and review them for accuracy.
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## **Determination of cost of facility**

When determining the cost of the facility, the rules of IRC sections 1012, 1014 and the accompanying regulations should be followed.

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## Section 3

### Limitations on Land Acquisition

#### Overview

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**Statutory Provisions** IRC section 147(c) provides the general rules regarding limitations of land acquisitions. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(16) of the 1954 Code.

There are no regulations applicable to this rule.

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**General Rule** IRC section 147(c) provides that a private activity bond will not be a qualified bond if:

- 25 percent or more of the NET PROCEEDS are to be used directly or indirectly for the acquisition of land or an interest in land, OR
  - any portion of the PROCEEDS is to be used directly or indirectly for the acquisition of land or an interest in land to be used for **farming purposes**.
- 

**Applicability** IRC section 147(c) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
  - qualified veterans' mortgage bonds,
  - qualified student loan bonds, AND
  - qualified 501(c)(3) bonds.
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## Overview, Continued

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### **Exception for First-time Farmers**

IRC section 147(c)(2) provides an exception to the general rule for land to be acquired by first-time farmers, if the requirements of IRC section 147(c)(2)(B) are met. A lifetime maximum of \$250,000 is available for this purpose. The limit does not include bond-financed land disposed of while the individual was insolvent.

First-time farmers may also use up to \$62,500 of the maximum \$250,000 to acquire used depreciable agricultural equipment.

If the requirements of IRC section 147(c)(2)(B) are met, then the provisions of IRC section 147(d), which prohibit specified acquisitions of existing property, will NOT apply to property purchased for farming purposes. (The provisions of IRC section 147(d) are discussed in Section 4.)

IRC section 147(c) also includes relevant definitions and rules regarding acquisitions from related persons and aggregation, which apply to acquisitions by first-time farmers.

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### **Exception for Land Purchased for Environmental Purposes**

IRC section 147(c)(3) provides an exception to the general rule limiting the amount of net proceeds which may be used to acquire land for any land acquired by a governmental unit (or issuing authority), if the land is acquired:

- in connection with:
    - an airport,
    - mass commuting facility,
    - high-speed intercity rail facility,
    - dock, or
    - wharf,
  - for noise abatement or wetland preservation, or for future use as any of the above, AND
  - there is no other significant use of the land.
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## Overview, Continued

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**Relationship  
With IRC  
Section  
147(b)(3)(B)**

It appears that there is some conflict between IRC sections 147(c) and 147(b)(3)(B). Recall from the previous section that IRC section 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land.

IRC section 147(b) applies to qualified 501(c)(3) bonds, but IRC section 147(c) does NOT apply to qualified 501(c)(3) bonds. Therefore, net proceeds of qualified 501(c)(3) bonds can be used to purchase land, however land is only taken into account when computing the average economic life of a facility when 25 percent or more of the net proceeds are used to finance land.

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## Section 4

### Acquisitions of Existing Property

#### Overview

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**Statutory Provisions**

IRC section 147(d) provides the general rules regarding the limitations on acquisitions of existing property. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(17) of the 1954 Code.

There are no regulations applicable to this rule.

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**General Rule**

IRC section 147(d)(1) provides that a private activity bond will not be a qualified bond if any portion of the NET PROCEEDS is to be used for the acquisition of any property, or an interest in property, unless the first use of such property is pursuant to such acquisition.

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**Applicability**

IRC section 147(d) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
  - qualified veterans' mortgage bonds,
  - qualified student loan bonds, AND
  - qualified 501(c)(3) bonds.
- 

**Used Property vs Property With Used Parts**

PLR 8929073 stated that used rails used in the construction of a new railroad line would not be separate property, but would constitute component parts of the entire track structure. Therefore, utilization of the previously used rail as a building material in the construction of the track structure would not constitute the utilization of property the first use of which did not begin with the taxpayer.

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## Overview, Continued

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### Exception for Certain Rehabilitations

IRC section 147(d)(2) provides an exception to the general rule for:

- buildings (and equipment for the building), if rehabilitation expenditures equal or exceed **15 percent** of the cost of acquiring the building (and equipment for the building) financed with the net proceeds of the bonds, AND
  - structures other than buildings (i.e. dry docks), if rehabilitation expenditures equal or exceed **100 percent** of the cost of acquiring the structure financed with the net proceeds of the bonds.
- 

### Rehabilitation Expenditures

IRC section 147(d)(3) provides that rehabilitation expenditures are amounts:

- properly chargeable to capital account, AND
- incurred in connection with the rehabilitation of a building.

Qualifying amounts incurred by a successor to the purchaser or by the seller under a sales contract with the purchaser are treated as incurred by the purchaser.

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## Overview, Continued

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### **Excluded Expenditures**

For certain expenditures which are not “rehabilitation expenditures,” IRC section 147(d)(3)(B) refers to IRC section 47(c)(2)(B), after December 31, 1990. The following expenditures described in IRC section 47(c)(2)(B) are generally NOT rehabilitation expenditures:

- expenditures for which the straight line method over a proper recovery method is NOT used,
- the cost of acquiring the building or interest therein,
- expenditures for the enlargement of an existing building,
- certain expenditures for the rehabilitation of historic structures,
- expenditures for rehabilitation of a building allocable to tax-exempt use property (within the meaning of IRC section 168), AND
- certain expenditures of lessees.

**(See Treas. Reg. sections 1.48-12(c)(7) through (10) and 1.48-12(d) for rules regarding the above expenditures. Note that because of the redesignation of IRC section 48 to 47, effective December 31, 1990, the regulations accompanying current IRC section 47 are in Treas. Reg. section 1.48.)**

**Also see PLR 8831033 included as Exhibit K-3 for treatment of an enlargement of an existing building.**

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### **Time Period**

Qualifying rehabilitation expenditures must be made on or prior to the date which is two years after the later of:

- the date on which the building was acquired, OR
  - the date on which the bond was issued.
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### **More Than One Building**

If a project involves two or more buildings, IRC section 147(d) is applied on a project, rather than on a building, basis.

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## Section 5

### Prohibited Facilities

#### Overview

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**Statutory Provisions**

IRC section 147(e) provides the general rules regarding prohibited facilities. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(18) of the 1954 Code.

There are no regulations applicable to this rule.

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**General Rule**

IRC section 147(e) provides that a private activity bond shall not be a qualified bond if any portion of the proceeds of the issue is used to provide any of the following:

- airplanes,
- skyboxes or other private luxury boxes,
- health club facilities
- facilities primarily used for gambling, OR
- stores the principal business of which is the sale of alcoholic beverages for consumption off premises.

Note that proceeds of qualified 501(c)(3) bonds are permitted to be used for health club facilities.

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**What is a principal business?**

Two private letter rulings consider whether or not wholesale distributors whose product line included alcoholic beverages were engaged in the principal business of the sale of alcoholic beverages for consumption off premises. **See PLR 8743008 and PLR 8646014 included in this text as Exhibits K-4 and K5.**

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## Section 6

### Public Approval Requirement

#### Overview

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##### Introduction

IRC section 147(f) requires that there be public approval of the qualified private activity bond either by:

- the “applicable elected representative” of a governmental unit, OR
- by voter referendum of the governmental unit.

Approval by the “applicable elected representative” requires a **public hearing** following **reasonable public notice** about the bond issuance. More than one governmental unit may be required to approve one bond issue. If so, each governmental unit required to approve the issue must have its own hearing.

This requirement is commonly known as the “TEFRA requirement” because it was originally added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

A private activity bond is not a qualified bond unless it has been properly approved.

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##### Statutory Provisions

IRC section 147(f) provides the general rules regarding the public approval requirement. Prior to the Tax Reform Act of 1986, these rules were in section 103(k) of the 1954 Code.

Treas. Reg. section 5f.103-2 also contains rules which pertain to the TEFRA requirement.

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##### Applicability

IRC section 147(f) applies to ALL qualified private activity bonds, without exception.

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## Overview, Continued

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**In This Section** This section contains the following topics:

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## Obtaining Approval

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### Issuer Approval

IRC section 147(f)(2)(A) provides generally that the governmental unit that must obtain the approval is the issuing unit or unit on whose behalf the bonds will be issued. This is called “issuer approval.”

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### Host Approval

Additionally, Treas. Reg. section 5f.103-2(c)(3) provides that each governmental unit the geographic jurisdiction of which contains the facility to be financed by the issue must approve the issue. This is called “host approval.”

However, if the entire site of the bond-financed facility is within the geographic jurisdiction of more than one governmental unit with a State, then any one of such units may provide host approval for the issue with respect to that facility.

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### Example 1

State X proposes to issue private activity bonds, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City Y. Only State X must approve the issue because State X is the issuer and the facility is to be located entirely within the State’s geographic jurisdiction. If the city issued the bonds, only the city would need to approve them.

### Example 2

County M proposes to issue private activity bonds to finance a project located partly within the geographic jurisdiction of County M and partly within the geographic jurisdiction of County R. Both counties are located in State X. The part of the project in County R is also located partly within the geographic jurisdiction of Cities O and P. County M must give issuer approval. Additionally, **either** State X, County R, or both Cities O and P must give host approval.

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## Obtaining Approval, Continued

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**Definition of  
“Applicable  
Elected  
Representative  
”**

IRC section 147(f)(2)(E) provides that the term “applicable elected representative” means with respect to any governmental unit:

- an elected legislative body of such unit, OR
- the chief elected executive officer, the chief elected State legal officer of the executive branch, or any other elected official of such unit designated for purposes of this paragraph by such chief elected executive officer or by State law.

If a governmental unit has no applicable elected representative, then the applicable elected representative shall be the elected representative of the next higher governmental unit:

- which has an elected representative, AND
- from which the authority of the governmental unit without one is derived.

**Example**

In Example 2 above, Counties M and R will approve the issue, but assume that neither has any officials who are elected at-large by the voters. Both governmental units derive their authority from State X, which is the next higher governmental unit with an applicable elected representative. Therefore, an applicable elected representative of State X must approve the issue for Counties M and N after the public notice and public hearing requirements are satisfied.

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## Reasonable Public Notice

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**What is  
“Reasonable  
Public Notice?”**

Treas. Reg. section 5f.103-2(g)(3) provides that reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the governmental unit where a facility is to be located, of the proposed issue.

The notice must state the time and place for the hearing and be published no fewer than 14 days before the hearing.

Treas. Reg. section 5f.103-2(g)(3) also contains rules regarding the permitted media, which may be used to notify the general public.

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**Notice Must  
Contain  
Certain  
Information**

Treas. Reg. section 5f.103-2(f)(2) provides that the notice of hearing and the approval must contain the following:

- a general, functional description of the type and use of the facility to be financed, such as:
    - a 10,000 square foot machine shop and hardware manufacturing plant,
    - a 400-room airport hotel building,
    - a dock facility for supertankers,
    - convention center auditorium and sports arena with 25,000 seating capacity, OR
    - air and water pollution control facilities for oil refinery.
  - the maximum aggregate face amount of obligations to be issued with respect to the facility,
  - the initial owner, operator, or manager of the facility, AND
  - the prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.
- 

*Continued on next page*

## Reasonable Public Notice, Continued

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### **Inadequate Notice**

Treas. Reg. section 5f.103-2(f)(2) provides that, aside from **insubstantial deviations**, approvals will only be valid if all of the required information is included. An approval or notice of hearing will not be adequate if any of the required information is unknown on the date of the approval or the date of the public notice.

### **Example 1**

State agency X proposes to issue bonds and lend the proceeds to section 501(c)(3) organizations. The specific organizations receiving the proceeds will not be known until after the issuance date. It intends to elect to qualify for the special maturity rule for pooled financings under section 147(b)(4). Before issuing the bonds, the agency will publish a notice containing a General, functional description of the type of facilities to be financed and the maximum aggregate amount of the obligations used to finance the facilities.

The Service ruled in PLR 9622032 that the agency's proposed approval and notice of public hearing violated IRC section 147(f) because the notice would not identify the initial owner, operator, or manager of the facility and its prospective location, as required under the temporary regulations.

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*Continued on next page*

## Reasonable Public Notice, Continued

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### Inadequate Notice, continued

#### Example 2

Authority W issued bonds and loaned the proceeds to Hospital B to finance the construction and renovation of capital facilities at the hospital, and to finance the acquisition of capital equipment. The bonds were qualified 501(c)(3) bonds under IRC section 145. A notice of public hearing for the bonds described the project, listed its location, and identified Hospital B as the initial owner. Although many of the specific items included within the project had been completed, approximately 25 percent of the bond proceeds remained unspent prior to Hospital B's merger with Hospital A. Thereafter, management decided to use the remaining bond proceeds to finance capital renovations and capital equipment at Hospital A.

The Service ruled in PLR 9508029 that the proposed use of the bond proceeds for Hospital A would be an **insubstantial deviation** from the public notice requirements of IRC section 147(f) and the regulations. The Service noted that the proceeds will be used in a nearby facility in the same manner as originally approved, and that none of the financed activities will have an impact on residents in the locality of the facilities.

**(See also PLRs 9609032 and 9452021.)**

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### Public Hearing

Treas. Reg. section 5f.103-2(g)(2) provides generally that a public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed.

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## Other Rules

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### **Time Frame**

IRC section 147(f)(2)(C) provides that once public approval has been obtained for a plan of financing a facility, that approval shall constitute approval for any issue:

- which is issued pursuant to such plan within three years after the date of the first issue pursuant to the approval, AND
  - all or substantially all of the proceeds of which are to be used to finance such facility or to refund previous financing under the plan.
- 

### **Refunding Bonds**

No approval is necessary for current refunding bonds as long as:

- the original bond met the public approval requirements, and
- the average maturity date of the refunding issue is NOT later than that of the refunded bond.

The public approval requirements of IRC section 147(f) must be met by advance refundings.

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## Special Rules for Approval of Certain Qualified Private Activity Bonds

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### **Airports and High-Speed Intercity Rail Facilities**

For the purposes of the public approval requirement, IRC section 147(f)(3) provides that a governmental unit will be considered to be the only governmental unit having jurisdiction over an airport or high-speed intercity rail facility if:

- the proceeds of the bonds are to be used to finance a facility located at an airport or high-speed intercity rail facility, AND
  - the governmental unit issuing the bonds is the owner or operator of the facility.
- 

### **Scholarship Funding Bonds**

IRC section 147(f)(4)(A) provides that for purposes of the public approval requirement, any governmental unit which made a request described in IRC section 150(d)(2)(B) with respect to the issuer of such bond shall be treated as the governmental unit on behalf of which the bond was issued.

When more than one governmental unit within a State has made the request, the State may also be treated as the governmental unit on behalf of which such bond was issued.

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### **Volunteer Fire Department Bonds**

IRC section 147(f)(4)(B) provides that for purposes of the public approval requirement, any volunteer fire department which meets the requirements of IRC section 150(e), the political subdivision described in IRC section 150(e)(2)(B) will be considered the governmental unit on behalf of which the bond was issued.

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## Auditing Techniques

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### **Bond Transcript**

Documents relating to TEFRA approval should be included in the bond transcript. If the transcript does not contain these documents, request them from the issuer.

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### **Subsequent Events**

Questions about compliance with the TEFRA requirement can arise after issuance because subsequent events can result in bond proceeds being used for a purpose different from that expected on the issuance date. Therefore, any examination of a qualified private activity bond should include a comparison of the facts as they are stated in the approval with the actual use of the bond proceeds.

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## Section 7

### Restrictions on Issuance Costs

#### Overview

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**Statutory Provisions**

IRC section 147(g) provides the rules regarding costs of issuance. These rules were added to the Code by the Tax Reform Act of 1986.

There are no regulations applicable to these rules.

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**General Rule**

IRC section 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed two percent of the **proceeds** (NOT face amount) of the issue.

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**Applicability**

IRC section 147(g) applies to all types of qualified private activity bonds.

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## Overview, Continued

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### Relationship with “95 percent” Test

As was discussed in prior modules, at least 95 percent of the net proceeds of certain qualified private activity bonds must be used for the exempt purposes of the issue. Amounts used to finance any costs of issuance are NOT treated as spent for the exempt purpose of the borrowing. Thus, these issuance costs may be financed only from the so-called five percent “bad money” portion of the issue.

Additionally, the amount of bond proceeds that may be used to finance costs of issuance is limited to two percent of the proceeds of the issue.

### Example

County E issues \$1,000,000 bonds and loans the money to Corporation F, which will own and operate a solid waste disposal facility. Use of proceeds is shown below:

\$1,000,000	Sale proceeds
< <u>100,000</u> >	Deposit to Reserve Fund
900,000	Net Proceeds
<u>    x .95</u>	
855,000	Portion required to be used for exempt purposes
45,000	5 percent allowed for nonexempt purposes (900,000 x .05)
<u>-20,000</u>	2 percent allowed for issuance costs (1,000,000 x .02)
25,000	Portion which can be used for non-issuance nonexempt purposes.

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### Relationship With IRC Section 141(b) Tests

With respect to the 10 percent private business/private loan financing tests of IRC section 141(b), bond proceeds used to pay issuance costs are included in this 10 percent “bad portion” as well.

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### Relationship With IRC Section 145 Private Use Test

Bond proceeds used to pay issuance costs are also included in the five percent “bad portion” of the 95 percent 501(c)(3) private use test of IRC section 145(a)(2)(B)

*Continued on next page*

## Overview, Continued

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**In This Section** This section contains the following topics:

<b>Topic</b>	<b>See Page</b>
Overview	K-33
Introduction	K-36
Calculating the Two Percent Limit	K-37
Auditing Techniques	K-38

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# Introduction

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## What are issuance costs?

Treas. Reg. section 1.150-1(b) includes the following costs as issuance costs:

- underwriter's discount,
  - counsel fees,
  - financial advisory fees,
  - rating agency fees,
  - trustee fees,
  - paying agent fees,
  - bond registrar, certification, and authentication fees,
  - accounting fees,
  - printing costs for bonds and offering documents,
  - public approval process costs,
  - engineering and feasibility study costs, AND
  - guarantee fees, other than for qualified guarantees.
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## Special Rule for Small Mortgage Revenue Bonds

IRC section 147(g)(2) provides that in the case of qualified mortgage or veterans' mortgage bonds, the issuance cost limit is increased to 3.5 percent if the bond proceeds do not exceed \$20 million.

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## Rule for Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds are subject to IRC section 147(g) despite the fact that 501(c)(3) organizations can issue bonds for working capital. 95 percent of the net proceeds (proceeds less deposit to reserve fund) must be used in a way that the IRC section 141 tests are NOT met, treating the 501(c)(3) organization as a governmental entity.

Treas. Reg. section 1.141-3(g)(6), which provides for ratable allocations of neutral costs among the purposes for which the proceeds are used, is NOT applicable to 501(c)(3) organizations. Instead, the costs of issuance are considered to be for private business use. **(See Treas. Reg. section 1.145-2(c)(2).)**

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## Calculating the Two Percent Limit

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### Example

County H issues \$12M principal amount of bonds on June 1, 1997, and loans the proceeds to Developer A to build a sewage facility. The bonds are sold at a premium, allowing County H to receive \$12.5M in sale proceeds. The county incurred the following expenses in connection with the bond issuance:

- underwriter's discount      \$120,000
- counsel fees                      75,000
- trustee fees                      20,000
- bond insurance premium      24,000

The 2% limit is calculated as follows:

Proceeds	\$12,500,000	
Deposit to Reserve	< <u>1,250,000</u> >	
Net Proceeds	11,250,000	
	<u>          x .95</u>	
To be used on project	10,687,500	
	11,250,000	
	<u>          x .05</u>	
5% allowed for bad costs	562,500	(11,250,000 x .05)
2% allowed for issuance costs	< <u>250,000</u> >	(12,500,000 x .02)
Can be used for other bad costs	312,500	

If County H uses more than \$250,000 to pay issuance costs, the bonds cannot be qualified private activity bonds.

The underwriter's discount, counsel fees, and trustee fees all qualify as issuance costs. The bond insurance premium may be treated as an interest expense under arbitrage rules, and, to the extent such premiums are treated as interest, do not count towards the 2 percent limitation on issuance costs.

Accordingly, total issuance costs paid by the county are equal to \$215,000. Therefore, the county has met the section 147(g) requirement.

Issuance costs are equal to 1.7 percent of proceeds. The \$215,000 is not counted toward meeting the 95 percent expenditure requirement. Instead, it is part of the 5 percent bad money portion leaving the county only 3.3 percent of the net bond proceeds to be spent on other than the exempt purpose for which the bonds were issued.

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*Continued on next page*

## Auditing Techniques

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### **Locating issuance costs**

Information about issuance costs is obtained from the “Use of Funds” schedule or from trustee records. Sometimes there will be a separate “Issuance Cost” account from which all of these costs are paid.

Outside funds can be used for issuance costs that exceed the 2% maximum.

Ask questions about ANY disbursements from ANY account which seem unusual or unclear. Issuance costs can be “hidden” in any account.

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## Summary

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### Review of Module K

Module K discussed the requirements of section 147 that must be met in order for a private activity bond to be a **qualified** private activity bond. IRC section 141(e), which defines qualified private activity bonds, explicitly provides that these requirements, as well as those of section 146, be met.

Even though a bond meets all of the requirements of IRC section 141(e), the bond must still meet the requirements of section 103 if the interest is to be tax-exempt.

Generally, the provisions of IRC section 147 as they apply to certain qualified private activity bonds are as follows:

- Section 147(a) prohibits the interest on bonds from being tax-exempt, if a substantial user of the facility financed by the bonds holds them.
- Section 147(b) limits the length of maturity of bonds to 120% of the life of the bond-financed facility.
- Section 147(c) limits the amount of net proceeds of bonds that can be used for land.
- Section 147(d) prohibits any portion of the net proceeds of bonds from being used to acquire existing property.
- Section 147(e) lists certain facilities, which may NOT be financed with bond proceeds.
- Section 147(f) requires that there be public approval of all qualified private activity bonds.
- Section 147(g) limits the amount of bond proceeds, which may be used for issuance costs.

An examination of any qualified private activity bond (unless specifically excepted from the rule) will include procedures to verify that all of the above requirements are met.

**Figure K-1** shows the section 147 requirements and their applicability to specific types of qualified private activity bonds.

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*Continued on next page*

## Summary, Continued

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### **Preview of Module L**

Although the provisions of IRC section 147 generally do not apply to governmental bonds, they can become relevant when a “change in use” occurs.

A change in use occurs when an event takes place subsequent to the issuance date which causes the bond-financed facility to be used for a purpose other than that expected when the bonds were issued.

Changes in use are common occurrences in municipal financings, because even the best plans do not always come through. Because these are common, and because bond examinations take place after the issuance date, agents need to be familiar with the change of use rules.

These rules are discussed in Module L.

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*Continued on next page*

**Summary**, Continued

**Figure K-1: Applicability of IRC section 147 Provisions**

Provisions apply unless otherwise noted.

<b>Type of qualified private activity bond</b>	<b>Substantial User</b>	<b>Maturity Limitation</b>	<b>Land Acquisition and Existing Property Limitations</b>	<b>Prohibited Facilities</b>	<b>Public Approval</b>	<b>Issuance Costs Restrictions</b>
Exempt Facility Bonds						
Mortgage Bonds	NA	NA	NA			Note 2:
Veterans Mortgage Bonds	NA	NA	NA			Note 2:
Small Issue Bonds						
Student Loan Bonds	NA	NA	NA			
Redevelopment Bonds						
501(c)(3) Bonds	NA		NA	Note 1:		Note 3:

Note 1: Qualified 501(c)(3) bonds may be used for healthclubs.

Note 2: Issuance cost limit equals 3.5 percent if proceeds do not exceed \$20 million.

Note 3: Treas. Reg. section 1.141-3(g)(6) is NOT applicable despite requirement that IRC section 141 be applied.

## Class Exercises

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### Exercise 1

To finance the construction of an exempt facility, City C plans to issue short-term bond anticipation notes (BANS) in the amount of \$89M. Nonexempt Corporation X that will be the owner of the facilities will purchase the BANS. All of the note proceeds will be used to pay the costs of constructing exempt facilities, as described under IRC section 142(a). After construction is completed, City C will issue long-term bonds in the amount of \$100M. \$89M will be used to retire the notes, while \$11M will be used to pay the accrued interest on the notes.

Question: Is the interest on the BANS tax-exempt?

Why or why not?

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### Exercise 2

Authority B issued bonds in April 1990 to finance expansion and remodeling projects of Hospital G. In connection with the bond issuance, the Authority published a notice of public hearing for the bonds that stated the proceeds were to be used for the acquisition, construction, equipping, and renovation of certain of its health facilities, and for refinancing of certain outstanding indebtedness of Hospital G. Project facilities were described as located on Site A, Site B, Site C, and Site D or on Site E. After completion of the project, Hospital G had bond proceeds left over (amounting to 3.2% of total bond proceeds) which it wished to use to construct a new medical clinic replacing the existing facility at Site F. None of the sites are geographically contiguous, but all are part of an integrated medical health care system.

Question: Is the use of bond proceeds for the new clinic at Site F an insubstantial deviation from the public notice requirements?

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## Class Exercises, Continued

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### Exercise 3

You are reviewing a “Use of Proceeds” schedule from the costs of issuance fund. The conduit borrower has spent nearly 2% on the costs of issuance.

Question: What else should you look at?

Question: What is not necessary to look at?

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END OF MODULE K

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